

SEC STOCK-OPTION EXEMPTION UPHOLD

Continental Oil Company v. Perlitz
176 F. Supp. 219 (S.D. Tex. 1959)

Plaintiff, a corporation, with its capital stock registered on the New York Stock Exchange, brought an action against one of its officers and directors, pursuant to Section 16(b) of the Securities Exchange Act of 1934,¹ to recover the profits realized by the defendant as a result of the sale and subsequent purchase of capital stock of the plaintiff. The defendant sold his shares on May 16 and 17, 1957, and purchased shares on August 28, 1957, in exercise of his rights under a restricted stock-option plan of the plaintiff.² The district court granted the defendant's motion for summary judgment. The court held that the Securities and Exchange Commission³ Rule X-16B-3⁴ was valid, and profits realized through the acquisition of stock pursuant to a restricted stock-option plan were exempt from the liability imposed by the Exchange Act.⁵

Prior to 1934, the majority of state courts had imposed no sanctions on directors, officers and other insiders⁶ who traded in their own company stock, buying and selling according to secret and advance information to which they alone had access.⁷ Congressional committees disclosed "the

¹ 15 U.S.C.A. § 78p(b) (hereafter referred to as the Exchange Act). "For the purpose of preventing the *unfair use* of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. . . . *This subsection shall not be construed to cover . . . any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.*" (Emphasis supplied.)

² The defendant purchased the stock on August 28, 1957, at a lower price than that received for a corresponding number of shares in the May, 1957 sales.

³ Hereafter sometimes referred to as the S.E.C. or the Commission.

⁴ 2 CCH Fed. Sec. Law Rep. Par. 25853. "Any acquisition of non-transferable options or of shares of stock including stock acquired pursuant to such options by a director or officer of the issuer of such stock shall be exempt from the operation of Section 16(b) of the Act if the stock or option was acquired pursuant to a bonus, profit-sharing, retirement, stock-option, thrift, savings or similar plan meeting all the following conditions:" The rule lists the strict limitations under which such plans will meet the exemption—the particular plan in the instant case meets these conditions.

⁵ 176 F. Supp. 219 (S.D. Tex. 1959).

⁶ 15 U.S.C.A. § 78p(a). "Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security). . . ."

⁷ *Carpenter, Adm'r. v. Danforth*, 52 Barbs (NY) 581 (1868); *Board of Comm'rs of Tipton County v. Reynolds*, 44 Ind. 509, 15 Am. Rep. 245 (1873); *Deaderick v.*

flagrant betrayal of their fiduciary duties and speculation in pools trading by directors, officers, and principal stockholders on the basis of information not available to the general public and small stockholders."⁸ Section 16(b) of the Exchange Act was enacted by Congress in 1934⁹ to protect these "outside" interests from at least short-term speculation of this nature.

To soften the "hardship of an admitted crude rule of thumb,"¹⁰ the S.E.C. was authorized to except certain transactions from the application of the Section.¹¹ Rule X-16B-3 was first adopted on October 9, 1935. It provided, at that time, for an exemption for certain transactions in connection with specific types of stock-option plans.¹² Because of the favorable tax treatment afforded restricted stock-options by the Internal Revenue Act of 1950,¹³ the rule was subsequently revised and amended, and on May 21, 1956, the S.E.C. issued a release which provided exemption for stock acquired pursuant to non-transferable options.¹⁴

The legality of the delegation to the Commission to provide for any exemptions at all was challenged in *Smolowe v. Delendo Corp.*¹⁵ The court said, however:

Wilson, 67 Tenn. (8 Baxt.) 108 (1874). A relatively small body of courts recognized the fiduciary relationship which directors and officers held and required a full disclosure of all material facts affecting the value of the shares. *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903). See 38 Mich. L. Rev. 133 (1939) for a general discussion of the common law cases.

⁸ Sen. Com. Rep. No. 792, 73d Cong., 2d Sess. at 9 (1934); "Stock Exchange Practices," Report of the Committee on Banking and Currency, Sen. Rep. No. 1455, 73d Cong., 2d Sess. at 55 (1934); For additional illustrations of insider trading abuses, see Pecora, "Wall Street Under Oath" 268-69 (1939).

⁹ *Supra* note 1.

¹⁰ *Smolowe v. Delendo Corp.*, 136 F.2d 231 at 240 (1943).

¹¹ *Supra* note 1; 15 U.S.C.A. § 78w(a). "The Commission and the Board of Governors of the Federal Reserve System shall each have power to make such rules and regulations as may be necessary for the execution of the functions vested in them by this chapter and may for such purpose classify issuers, securities, exchanges, and other persons or matters within their respective jurisdictions. . . ."

¹² Exemption from Section 16(b) liability was provided if the stock-option met the following conditions: (1) the purchase was pursuant to a non-transferable option granted prior to June 6, 1934, in connection with an employment contract, (2) the sale was made subsequent to October 9, 1935, (3) the plan was approved at a stockholders' meeting, and (4) the price of the stock under the option was at least as high as the market price of the stock at the time the option was granted. On February 25, 1949, the Commission withdrew the old rule and substituted one which dealt with bonus, profit-sharing or similar plans. 1952-56 CCH Fed. Sec. Law Rep. Par. 76388, Exchange Act Release No. 5312. May 21, 1956.

¹³ 26 U.S.C.A. § 130A; now § 421, I.R.A. 1954, 26 U.S.C.A. § 421; 26 U.S.C.A. §§ 401, 404.

¹⁴ *Supra* note 12. The rule was amended in 1952 to exempt purchases pursuant to restricted stock option plans which met the same standards as had been provided in the rule for bonus plans. The last amendment in 1956 added purchases of non-transferable options and eliminated the provision requiring the security to be received from the issuer for services.

¹⁵ 136 F.2d 231, 148 A.L.R. 300, *cert. denied* 320 U.S. 751 (1943).

Guiding the Commission in the exercise of an actually limited authority is the quite adequate standard . . . that its regulations be consistent with the expressed purpose of the statute¹⁶ The delegation serves no other than the commendable function of relieving the statute from imposing undue hardship and of giving it flexibility in administration.¹⁷

Serious doubts concerning the validity of the rule itself were created by the decision in *Greene v. Dietz*.¹⁸ Plaintiffs, stockholders in the corporation, sued to recover profits realized by the defendants, directors and employees of the corporation, as a result of sales of stock at higher prices than that paid when the stock was purchased under a restricted stock-option plan of the corporation. Although the majority opinion affirmed the decision for the defendants because they had acted in reliance on the rule,¹⁹ the court said,

Indeed, although not essential to our opinion, we express doubt as to the power of the Commission to promulgate Rule X-16B-3 inasmuch as the Rule's broad language may permit acts by insiders sought to be prevented by the Securities Exchange Act²⁰

Later cases²¹ arising under Section 16(b) and Rule X-16B-3 similarly held for the directors or officers who had made profits acting in good faith reliance on the rule,²² although the opinions reflected the concern over the effect of the dictum in the *Greene* case.

The significance of the instant decision is two-fold. First, there is the re-affirmation of the judicial confidence in the Commission's expertise on these highly technical matters and its ability to formulate rules and regulations within its delegated powers. Second, and most important, is the effect that the decision will have in clearing the confusion that has reigned since the *Greene* case. The court has recognized that the purpose behind the statute was to prevent abuses of fiduciary relationships and not to impose absolute liability on transactions which are open and above board. The instant case reflects the argument of the Commission in its memorandum filed in the *Greene* case: "It does not follow that because some stock-options are pregnant with fraudulent possibilities that every type of option is necessarily so."²³

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¹⁶ *Supra* notes 1 and 8.

¹⁷ *Id.* at 240.

¹⁸ 247 F.2d 689 (1957).

¹⁹ 15 U.S.C.A. § 78w(a). ". . . No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission or the Board of Governors of the Federal Reserve System, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason."

²⁰ *Id.* at 692.

²¹ *Gruber v. Chesapeake & O. Ry.*, 158 F. Supp. 593 (N.D. Ohio 1957); *Perlman v. Timberlake*, 172 F. Supp. 246 (S.D. N.Y. 1959); *Emerson Elec. Mfg. Co. v. O'Neill*, 168 F. Supp. 804 (E.D. Mo. 1958).

²² *Supra* note 19.

²³ CCH Fed. Sec. Law Service, Current, Par. 90,821 at 92577.